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Economists, Institutions, and Trade Restrictions:

A Review Article

J. Michael Finger

Experts on international trade analyze the "new" rationale for trade intervention and conclude it is neither new nor rational.

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Experts on the new economics of trade restrictions address such questions as:

Are there holes in the case for free trade?

It is difficult to know when there is profit to be captured by trade intervention and difficult to design the appropriate trade intervention policy. A tariff will sometimes capture the foreign profit while a quota will give away the domestic, or vice versa, and as Gary Saxonhouse observes, "Capturing a strategic sector and its attendant economic rents may be very important for firm equity holders without being of much significance for the economy as a whole."

Why are trade restrictions imposed?

Trade policy is often aimed at noneconomic objectives. About one sanction in three succeeds in its objective. Is this score good or bad? According to Stephen Krasner, "Since economic sanctions are likely to be used only when other policy instruments fail, this level of success is indeed surprising."

According to Rudiger Dornbusch and Jacob Frankel, "Net foreign demand is a more important determinant of protectionism than domestic demand." (Protection is provided mainly to offset losses of sales to foreign competition, not to compensate for losses attributable to an internal cause such as a shift of demand away from the product.)

How do U.S. policy actions and those of other nations interact?

Says the reviewer: "The two principles of policy advice that this book brings forward, 'Rules, not discretion,' and 'Tit-for-tat retaliation,' could be used both to endorse most of the protectionist legislation submitted to the U.S. Congress in the past 20 years, and to indict the GATT as wrong-headed. This is probably a result of policy interpretations made for the convenience of analytical models rather than analysis fitted to the facts of policy."

Says the reviewer about the "us" these economists represent:

We produce a quality product.

We sell it very poorly.

We place self-destructively narrow limits on the topics we will analyze.

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ECONOMISTS, INSTITUTIONS, AND TRADE RESTRICTIONS: A REVIEW ARTICLE a/

J. Michael Finger

All the top international trade people have contributed to this volume -- except four and those four have provided blurbs for the dust cover, saying it is a great book. Perhaps it is great, and surely the book is representative of contemporary analysis of trade restrictions. Published in it are 8 papers by many of the major contributors to the new economics of trade restrictions -- Dixit, Krugman, Srinivasan, Magee-Young, Dornbusch-Frankel, Cooper, Deardorff-Stern, Corden. One chapter is by a lawyer, John H. Jackson, but is not at all out of place in the volume. There are 2 "Comments" on each chapter except Corden's, (several by leading political scientists) and an "Introduction" providing a good summary of each of the 9 chapters. These papers and comments were presented at a symposium at the University of Michigan -- one of several initiatives of the university's regents and president "to bring faculty expertise to bear on some of the economic and social challenges facing [the state of] Michigan." (p. vii).

While the book is a collection of chapters by different authors, the chapters tend to speak with one voice, which I will interpret as the voice of the archetype or representative practitioner of contemporary economic analysis of trade restrictions. Those of us who work in this area but did not participate in the University of Michigan symposium should be proud to consider those who contributed to this volume as representative of our

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a/ The book under review here is U.S. Trade Policies in a Changing World Economy, Robert M. Stern, editor, Cambridge, Mass., MIT Press, 437 pp.

group. I hope also for acceptance of another of my presumptions -- that this book is representative of our analysis and of our communicating this analysis out of our group, say to persons who might be, among other things, regents of a leading university. I will then treat the book as "our" collective product.

Besides attempting to inform you of the book's contents, I want in this review to make three comments about "us," to wit:

- We produce a quality product.
- We sell it very poorly.
- We place self-destructively narrow limits on the topics we will analyse.

I. SUBSTANCE

In substance, the material in the book relates to 3 distinguishable, though overlapping questions:

1. Are there identifiable circumstances in which a trade restriction has greater economic benefits than costs, i.e., are there significant holes in the case for free trade?

2. Why are trade restrictions imposed, i.e., what are the circumstances that lead to them being imposed (rather than the effects that follow from them)?

3. How do trade policy actions of one state affect the actions of other states, and how can this knowledge be used to make the collective trade policy outcome better?

The Case Against Free Trade

Several of the chapters together provide a careful review of the "new" rationales for import restrictions:

(a) Firms in imperfectly competitive industries earn excess profits, or rents, that well-designed trade interventions might redirect from foreign to domestic firms; this "unrequited transfer" providing a net benefit to the national economic interest.

(b) Some sectors are "critical" to the development or efficiency of the rest of the economy, i.e., generate externalities, benefits for the rest of the economy beyond those captured by the sector's sales revenues.

Profit-capturing trade intervention is examined in the chapter by Alan V. Deardorff and Robert M. Stern, also in Paul Krugman's chapter. Each chapter points out that it is difficult to identify the circumstances in which there is profit to be captured by trade intervention -- in part because trade increases the degree of competition in any sector (a point also made by Avinash Dixit). Furthermore, it is not easy to design the appropriate policy. Depending on criteria that are hard to make operational, a tariff will sometime capture the foreign profit while a quota will give away the domestic, or vice versa. Another critical point is well summarized by Gary R. Saxonhouse "...capturing a strategic sector and its attendant economic rents may be very important for firm equity holders without being of much significance for the economy as a whole." (p. 241)

As to the case for critical sectors, Paul Krugman points out that this argument is, analytically, a rediscovery of the "structuralist" view of economic development, a somewhat faded view that was debated in the 1950's and 1960's. And Krugman adds, for a country's international position in a critical industry to affect the country's position in other sectors, "external economies must be country specific -- and in many cases they are not. Knowledge diffuses across international boundaries; intermediate goods can be traded. Whenever the external economies are international in scope, special concern about sustaining sectors in international competition is misplaced." (p. 231). Gary Saxonhouse points out that the same argument is presented in Marshall's _Principles_ against much the same rationale for government intervention.

T.N. Srinivasan's essay reviews the case for trade intervention in favor of sectors that produce "noneconomic" externalities, such as national defense. An import tariff, he reminds us, is a tax on consumption and a subsidy to production, an export duty the converse. If national defense is related to production or consumption of something (_e.g_, guns) a trade tax or subsidy is not the least cost way to achieve it. Only when security objectives _directly_ involve the amount of foreign trade is a trade intervention the best policy. The principle underlying this leads to straightforward policy advice, "Tax or subsidize _precisely_ what you want less or more of." The simplicity of the good sense of this should not cause one to overlook its importance or its wide applicability.

In sum, the book breaks the new rationale for trade intervention into analyzable parts, and shows that none of the parts hold up under careful analysis. This new rationale, it turns out, is not very new, nor is it very rational.

While this volume does not make the point, this is not the first time the case for free trade has survived challenges to its assumptions. Haberler's Theory of International Trade, published in 1936, demonstrated that the labor theory of value was not a critical assumption. Ron Findlay in a recent review of a collection of Haberler's papers points out that "Haberler's celebrated 1950 Economic Journal article on 'Some Problems in the Pure Theory of International Trade' ... was the product of irritation initiated by Thomas Balogh's belief that the familiar list of unrealistic assumptions usually made in expounding the theory of comparative advantage and the associated case for free trade [is] logically necessary for the validity of the conclusion." (Findlay, p. 1347)

Determinants of Protection

The book provides a less complete review of this topic. In one chapter, Rudiger Dornbusch and Jacob Frankel examine possible macroeconomic determinants of protection and conclude that "net foreign demand is a more important determinant of protectionism than domestic demand." (p. 99) While protection might provide an import-competing industry with "relief" from a decline of domestic demand as well as from an increase of foreign competition, the direct import of this finding is that protection is, in the main, provided only to offset losses of sales to foreign competition; not to compensate for losses attributable to an internal cause such as a shift of demand away from the product.

Dornbusch and Frankel also examine the influence on net demand for US manufactured goods of the 1980's overvaluation of the dollar and, by implication (through the previously demonstrated link between net foreign demand and protection), the influence of dollar overvaluation on US protectionism. They find that in some industries the real dollar exchange rate is significantly correlated over time with employment (steel, metal fasteners, but not in the autos or textiles industry) and in these cases offers "some support for the hypothesis that the overvalued dollar explains recent protectionist actions." (p. 112) (Additional evidence on the link between the exchange rate and employment is cited by William Branson, in his comment.) They then ask why, if overvaluation of the dollar leads to protection in the US, the inverse undervaluation of trading partner currencies does not reduce protection in those countries? Several ad hoc explanations are offered, e.g., an exogenous increase of protectionist sentiment, a ratchet effect.

Stephen P. Magee and Leslie Young present protection in the US since 1900 as the outcome of "maximizing, self-interested behavior by all of the economic agents, lobbies, political parties, and voters" (p. 147), but their exercise provides little insight into the what or why of trade restrictions. Edward Leamer in his comment on the chapter lists 9 points on which Magee-Young's assumptions do great violence to reality. Milton Friedman has observed, Leamer reminds us, that useful theories often have unrealistic assumptions. But, Leamer chides Magee-Young, Friedman's observation does not mean that the unreality of one's model assures its predictive usefulness. In this case not only are the assumptions unreal, the predictions are bizarre -- described by Magee-Young themselves as 3 "paradoxes," 2 "ironies," 1 "conflict" and 1 "surprise."

Perhaps the major lesson the book provides on the determinants of trade policy is that trade policy is often aimed at noneconomic objectives. War is the pursuit of diplomacy through other means -- trade policy too, points out Richard Cooper, whose chapter explains that over US history trade policy has had considerable importance for and influence on major foreign policy questions. Creating a national identity was, in our early history, an important object of trade policy, e.g., trade boycotts during colonial days to protest the Stamp Act and the Townsend Act. Cooper sees trade policy from about 1820 to WWII as aimed chiefly at trade objectives -- to protect US manufacturing and at the same time promote US exports. After WWII came liberalization under the GATT, liberalization motivated more by a desire to preserve peace and to assure international stability through economic means than by an appreciation of the economic gains from trade.

Several chapters review historical attempts by the US to use trade embargoes to influence the economic, political or military behavior of other countries. Examples are the 1965-78 trade embargo against Rhodesia, the trade embargo to protest the Stamp Act imposed on the American colonies by Great Britain, the Jackson-Vanik amendment of 1974, seeking increased Jewish emigration from the Soviet Union, various trade and financial measures against Iran in an attempt to gain release of American hostages. Such sanctions have had diverse and sometimes imprecise objectives, and there are several disagreements among authors as to whether or not a particular sanction achieved its objective.

Much of this discussion draws on information from Gary Hufbauer and Jeffrey Schott's book on US export sanctions and ends up more or less with their conclusion -- in about 1 case in 3 sanctions were successful in achieving their objective. Is this a good or a bad score? Stephen Krasner's evaluation is, "Since economic sanctions are likely to be used only when other policy instruments fail, this level of success is indeed surprising." (p. 329)

No attempt is made to attach a dollars and cents value to these foreign policy objectives or to identify the costs of the policies put in place in pursuit of them, i.e., the test applied is "Did they work?" rather than the more stringent economic test "Was it worth it?"

Policy Interactions

Avinash Dixit's chapter, titled, "How Should the United States Respond to Other Countries' Trade Policies?" provides an excellent introduction to the relevant literature. Dixit divides the question into two parts:

(a) the best reaction to foreign policies, given that the US policy choice will not affect trading partners' policy choices;

(b) how US policy actions will influence the policy choices of trading partners.

Dixit's reading of relevant research is that our trading partners' policies are not "predatory" -- will not, in the long run, leave the US in a position to be exploited by foreign monopoly sellers of products we import. The best reaction then to foreign trade policies is "None at all." This does not imply that the US should have no trade policy -- rather, that the wisdom of US trade policy is a matter of how US policy affects US interests, given existing circumstances, not of how foreign policies have affected these circumstances.

Most of Dixit's chapter, and a major part of Deardorff and Stern's discuss how one country's policy actions will influence the policy choices of others. Attention centers on Prisoners' Dilemma situations -- if no country restricts trade, each is better off than if all restrict, yet whatever other countries do (restrict or not) an individual country would benefit from restricting. Thus collective action, in the form of an effective agreement by all not to restrict, is better than the end result of each country independently choosing the policy best for itself. But how, among sovereign states, does one make effective such a free trade agreement? Two policy principles are endorsed by several authors. One of these is policy rules (rather than administrative discretion); i.e., "Policy mechanisms should be based on firmer and clearer rules and allow less discretion after the fact." (p. 279) The other is tit-for-tat responses, i.e., "Work on this problem [the Prisoners' Dilemma] suggests the desirability of being committed to retaliation." (p. 62)

here are several endorsements of these policy principles, and a couple of other (not necessarily conflicting) prescriptions. Robert Keohane suggests "mixed strategies that combine the openness ... of unconditional MFN with the incentives to cooperate inherent in reciprocity" (p. 405), John Jackson favors "dispute settlement, norm formation, and a number of other procedures ... that can effectively manage interdependence in today's complex world" (p. 395), and Max Corden offers a 6-element sketch of a new multilateral trade agreement.

There is not much policy analysis. Other than a comment or two that the recent increase of trade restrictions is because "important members ... bypass or ignore GATT authority and obligations" (p. 3) and because the GATT "contained several loopholes and escape clauses that could be misused and duly were" (p. 245) the book provides no attempt to interpret current policy or policy-making process in the light of the principles it endorses.

II. DELIVERY

Economic theory has great power to clarify important issues of public policy, but its application to such issues by contemporary economists does not often demonstrate this power to the policy community. "All the economists of the world if laid end-to-end, would not reach a conclusion," is a jibe we have all suffered. It is unfortunate, but this book does more to demonstrate that such criticism is warranted than to set it aside. One such demonstration is that the book fails to argue a conclusion that it, in substance, very strongly supports. Furthermore, it flaunts inconclusiveness as if it were one of our tribal values -- "As might be expected from an economist, I have produced a catalog of alternatives instead of a clear answer." (p. 279), and "I aim to contribute to clarification rather than urge a particular point of view." (p. 413)

As to what it might have concluded, the book provides the blows to pound the stuffing out of the "new" reasons for import restrictions, but it uses this reasoning in an almost apologetic way to present the case for free trade. The "case against" is clearly stated, e.g.:

> "What should we as international trade economists be advising policymakers to do? The classical case for the gains from trade is not very helpful in this regard since it posits a world so far removed from the reality in which policymakers have to operate. .... [T]he theoretical developments [reviewed in the book] indicate that our profession is beginning to confront many of the complexities of the 'real world'. The

answers are only beginning to emerge, but the progress being made is encouraging nonetheless." (p. 16)

[T]he conventional economist's wisdom is open to challenge, for it is based on insecure foundations. In particular, the assumptions that competition is perfect, on the one side, and that private and social returns are equal, on the other, are clearly untrue." (p. 208)

The "conclusion for" is much less forceful:

"[A]lthough recent arguments for trade intervention have been diverse, we do not consider them as sufficient grounds for seriously compromising or rejecting outright the principles of free trade as the basis for trade policy." (p. 34)

Compare the following argument:

Ay, tear her tattered ensign down!
Long has it waved on high
And many an eye has danced to see
That banner in the sky;

. . .

Her deck, once red with heroes' blood,
Where knelt the vanquished foe,
Where winds were hurrying o'er the flood,
And waves were white below,

No more shall feel the victor's tread,
Or know the conquered knee; --
The harpies of the shore shall pluck
The eagle of the sea.

When Oliver Wendell Holmes wrote these words (in 1830), the US Navy was about to sell "Old Ironsides" for scrap. Her oak and canvas it seemed, were irrelevant to contemporaneous conditions. Yet "Old Ironsides" was saved and still floats in Boston harbor. Holmes' counterargument had little substance, but it moved a nation to action. At the other extreme, the analysis in the book under review is precise, careful, fair-minded, even generous. It shows in substance, that through storms of rent-snatching and minefields of externalities, "Free Trade" sails robustly on.

But in form it praises through many verses the harpies of the shore -- then in the end admits that the eagle got away. Its substance is betrayed by argumentation that is feckless, devoid of spirit.

The last matter I want to take up in this review is the limits we place on what we will analyze. As noted above, the book delivers policy advice, but little policy analysis (except for John Jackson's legal analysis). There is no inconsistency here, because the advice is given at a level of abstraction above institutional context, and actual policy is, of course, a part of the institutional structure. The policy principles the book advances -- (a) tit-for-tat responses and (b) rules, not discretion -- are suggested as desirable characteristics of any policy-making apparatus, whatever its particular legal or administrative forms might be.

These policy principles, when projected into the environment of policy and policy process, however lead to ambiguous endorsements of what is good or bad. For example, US trade law provides "rules" of the form "If condition 'A' exists in industry 'N', then the US government will restrict imports sufficiently to offset that condition." (Such "trade remedies," e.g., safeguards, antidumping and other such procedures, are explicitly condoned by the GATT.) The law allows the President to set aside some determinations that a "remediable" condition exists, and not impose an import restriction.

An increase of protection, in this institutional environment, often takes the form of Congress passing a law that adds to the list of "remediable" conditions and that crimps the President's discretionary authority to set "remedies" aside -- by expanding what is covered by rules, contracting what is covered by discretion. To call for "Rules, not discretion" is then to endorse the protectionist element in every trade bill the US Congress has passed since WWII.

As to tit-for-tat responses, the GATT-founding fathers wanted to prevent countries from following automatic retaliation rules. The GATT tries to interject international discussion into national decisions to retaliate. Through discussions of possible effects and appeal to the agreed international standard, perhaps the "first" country might be convinced to repeal or reduce its action, or the "second" convinced not to contribute to successive rounds of beggar-thy-neighbor protection. If the GATT process is followed, there are bilateral consultations, independent fact-finding, legal interpretation, and multilateral discussion -- after which retaliation might be authorized by vote of the GATT-contracting parties. A law requiring tit-for-tat retaliation put in place, say, by adding, in US law, foreign countries' trade restrictions to the list of remediable conditions, would be quite contrary to the intent of the GATT.

In sum, the GATT clearly tries to discourage countries from acting according to an automatic rule for retaliation, and it condones "if-then" rules of national behavior that prescribe import relief whe- certain conditions exist in a domestic industry. The two principles of policy advice that this book brings forward, "Rules, not discretion," and "Tit-for-tat retaliation," could be used both to endorse most of the protectionist legislation submitted to the US Congress in the past 20 years, and to indict the GATT as wrong-headed.

This is probably not our intent but rather, a result of policy interpretation made for the convenience of analytical models rather than analysis fitted to the facts of policy. A more pointed example of our instinct for what is the "horse" and what the "cart" of economic analysis is the attention the book devotes to questions of trade strategy in a Prisoner's Dilemma situation -- in which a country's national economic interest is augmented by its trade restrictions. (In the subject index there are 3 references under "Trade liberalization," 1 under "Free trade," and 13 under "Prisoner's Dilemma.") Though another part of the book argues carefully against the new rationale for trade intervention, there are no objections to the relevance of the assumption that a country benefits from its trade restrictions, and no suggestions that the "dilemma" be resolved by advising that unilateral restrictions do not serve the national interest. The possible exception is a backhander from Paul Krugman, "I would be surprised if a vigorous attempt to apply the principle of optimal intervention would not actually lead to considerably freer trade than we now have." (p. 231)

If we assume that our sympathy for the GATT or our antipathy for a particular trade law follows logically from policy principles such as this book recommends, then our policy advice will be, in the policymaking environment, not only abstract, but arbitrarily -- big on <u>preaching</u> what policy should be, but weak on <u>observation</u>, i.e., knowing what it in fact is. We then come across somewhat pompously -- like a shopper who has his proud say on price but, not knowing the currency, must trust the seller to count out the appropriate coins from his purse.

Yet our tendency is to avoid the task of fitting together our policy principles and the institutional context. The aphorism "Theory is made by first-rate minds, translated into policy by second-rate minds, and third-rate minds then apply that policy" is less a positive statement than a normative one. It specifies how our job classifications map us into our pecking order.

The accompanying presumption, that our policy principles will then be applied by a grateful policy community, is unwarranted. For a sophisticated product to gain a wide market, its user characteristics must be designed in, not added on after. Only commodities are marketed otherwise, and as policy advisors, we are no longer in the commodities business. (Someone familiar with Adam Smith or Alfred Marshall might insist that we never were.)

A recent cartoon makes the same point. In it, a group of British businessmen face a group of Japanese buyers. One of the British is wearing earphones, connected to two enormous packs, one strapped to his chest, the other to his back. The caption asks "The new British lightweight walkman, for instance! Why won't you people buy it?"

The community that makes and applies economic policy -- does it have any choice but to understand policy principles at the level of abstraction professional economists want to provide them, then fit them to the relevant institutional context? Of course it does. Few people achieve policy-making authority by insisting that they do not know the basis for it, and few of them are professional economists. David Henderson's amusing and informative book gives many examples of the dominance of "home-made" economics in the policy process. These do-it-yourselfers would hardly recognize that understanding and applying good economics is an alternative, much less be inclined to choose that alternative.

To sum up, much of what is in this book makes much better sense than the logic that usually underlies the making of trade policy. But the book speaks only to well-trained economists. Much of what is wrong in the book could be fixed by a determined concern to write better. Clarity and inconclusiveness, my English teachers taught me, are substitutes, not complements. If we were all forced to meet the demands of a very tough English teacher we would end up writing better economics.

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